

Is Indemnification a Barrier to Public-Private Partnerships?

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The Department of Defense has designated public-private partnerships for depot maintenance as a key maintenance and logistics enabler to improve operational readiness and reduce costs of weapon systems. During management forums and through other means since partnerships started to form in 1994, some private firms have expressed reservations about partnering with a government maintenance depot because of the requirement that they indemnify the government contracting activity for any loss or damages the private firms might incur.

Until 2001, a federal statute allowed private firms to pursue damage claims against a government depot only if a loss was caused by willful misconduct or gross negligence. Further legislation passed in December 2001 allowed private firms, in certain partnership situations, to recoup losses caused by “failure of the Government to comply with quality, schedule, or cost performance requirements in the contract.”¹

But that expanded language did not fully satisfy industry concerns. Subsequently, the Assistant Deputy Under Secretary of Defense for Logistics and Materiel Readiness (Maintenance Policy, Programs, and Resources) (ADUSD[L&MR]MPP&R) tasked LMI to study this issue, compare the current state of affairs with standard commercial practice, and determine the effect of the legislative change on the willingness of private firms to enter into public-private partnerships.

Our overall conclusion is that current indemnification requirements are at most a low-level concern, and they pose no barrier to the growth of public-private partnerships.

The findings in this paper stem from research into contract language both before and after the legislative change in December 2001 and interviews with members of the Product Support Committee of the Aerospace Industries Association (AIA), members of the Defense Contract Management Agency (DCMA), and legal professionals. Feedback from the AIA was especially important, because it

¹ Title 10, United States Code, section 2563 (c) (3).

was this organization that provided the impetus for the December 2001 statutory amendment.

STUDY OBJECTIVES

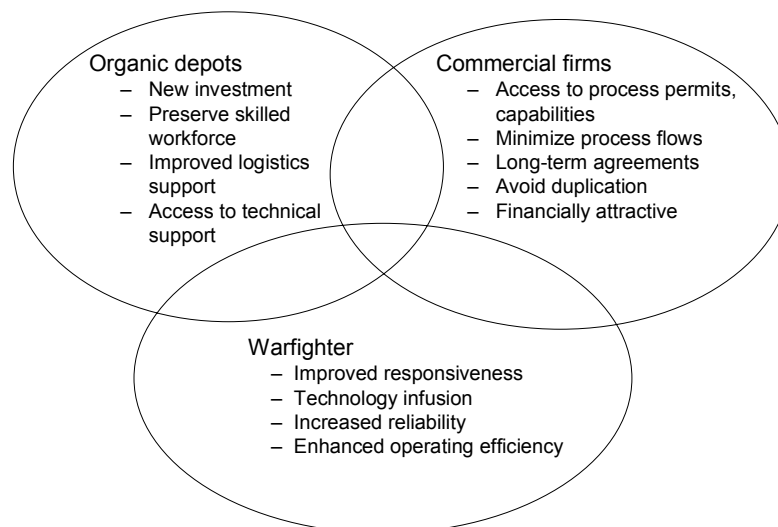
This study had three objectives:

- ◆ Determine how the issue of indemnification is treated in contract language between commercial firms.
- ◆ Determine how the issue of indemnification was covered in public-private partnership contracts prior to the public law change in December 2001.
- ◆ Determine whether the perceived level of risk on the part of private firms has been resolved by the statutory change or is still a barrier to growth in public-private partnerships.

Why Partnerships?

A fundamental goal driving this study is that the government seeks to increase the number of partnering arrangements for depot maintenance. The reason for such interest in expanding the use of public-private partnerships is that effective partnerships are a “win-win-win” for all three parties involved—the organic (Department of Defense) depot, the private firm, and, most importantly, the warfighter. The benefits to each, illustrated in Figure 1, are measurable and realistic.²

Figure 1. Benefits of Depot Maintenance Partnerships



² Logistics Management Institute, *Public-Private Partnerships for Depot-Level Maintenance*, Report LG101L2 (Rev. 1), Steven R. Erickson, March 2002.

As with any business arrangement, such partnerships entail various risks. In particular one partner may not perform according to the agreed terms, exposing the other to consequent damages or losses. As we will explain, federal statute limits the government's risk by requiring the private partner to indemnify the government against losses; the private partner, for its part, may seek to incorporate numerous other commonly used mechanisms into the contract to mitigate its own risk.

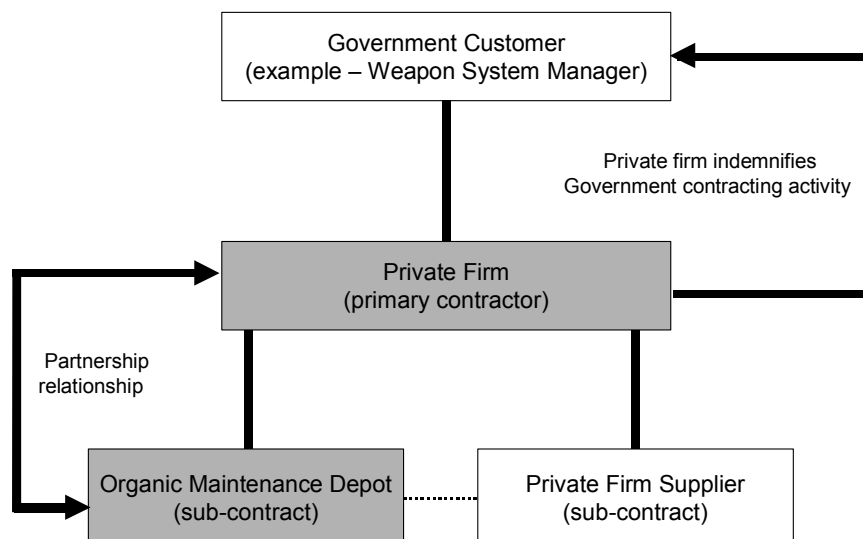
Background

In a public-private partnership, federal law requires the private firm to indemnify (or "hold harmless") the government from any loss or damages the private firm may incur as a result of partnering with a government-owned depot. This relationship is illustrated in Figure 2.

In this example, the government customer is a weapon system program office that contracts with a private firm for maintenance and logistics support of the weapon system. The contract between the government customer and the private firm clearly outlines what the deliverables are and how they are measured.

The private firm seeks the best way to obtain the results expected; in this case, it partners with both an organic (government) maintenance depot and another private firm that functions as a parts supplier. The partnership arrangement at issue in this paper is the relationship between the primary contractor and the organic depot (both shaded entities in 2). Typically, the government customer pays the primary contractor, and the primary contractor pays its subcontractors, including the organic government depot.

Figure 2. Typical Organizational Structure of Public-Private Partnership



In terms of depot maintenance, the Office of the Secretary of Defense defines a public-private partnership as “an agreement between an organic depot maintenance activity (or its agent) and one or more private industry or other entities to perform work or use facilities and equipment.”³ In the same memo, the DUSD(L&MR) states “it is in the mutual interests of both sectors to pursue the establishment and effective operation of partnerships across the widest possible segment of our workload requirements.”⁴

For partnerships to continue to grow, they must have sufficient economic appeal for both the private firm and the government partner (in this case, the organic maintenance depot). A potential disincentive is a private firm’s perceived risk of contractual penalties, legal liability, or other loss due to non-performance by the government entity with which they partner or sub-contract.

Until December 28, 2001, a private firm had to agree to hold a public-entity partner harmless for all cases of performance failure except “willful misconduct or gross negligence.” The statute (10 USC section 2563) until that point read as follows:

[T]he purchaser (private firm) agrees to hold harmless and indemnify the United States, except in any case of willful misconduct or gross negligence, from any claim for damages or injury to any person or property arising out of the articles or services.⁵

Since the first such partnerships were formed in 1994, private firms regarded this requirement as a potential barrier and used various maintenance forums, roundtables, and industry association meetings to voice these concerns. The private firms felt the “hold harmless” clause imposed a degree of risk they found burdensome. They had two main concerns:

1. If their public-entity partner failed to perform to expectations in the area of quality, schedule, or cost, and the private firm suffered contractual penalties, losses, or damage because of this non-performance, they felt they did not have sufficient legal grounds to recoup these losses from their public-entity partner.
2. Because the law required the purchaser of services to indemnify the government against claims for damage or injury to any person or property, the private firms felt they would be liable for all damages to any person injured or property damaged as a result of the public partner’s failure to meet contract quality requirements. They felt they bore the full burden of legal liability. Essentially, private firms viewed this burden as an “unbounded risk.”

³ Deputy Under Secretary of Defense for Logistics and Materiel Readiness, “Public-Private Partnerships for Depot Maintenance,” a memorandum for secretaries of the military departments, January 30, 2002, p. 3.

⁴ Ibid.

⁵ 10 USC section 2563 (c) (1) (B), prior to amendment.

On December 28, 2001, as a response to these concerns, Congress amended Title 10, section 2563, to add that the hold harmless clause also does not apply if the private firm suffers damages or loss due to “failure of the Government to comply with quality, schedule, or cost performance requirements in the contract.”⁶ This exception was in addition to the pre-existing one for “willful misconduct or gross negligence.” The intent of the change was to mitigate the perceived risk to a private firm and remove this perception of risk as a barrier to the growth of public-private partnerships.

In order to receive the benefit of this legislative change, the partners need to invoke 10 USC 2563 or 10 USC 2474 as the statutory authority for forming the partnership.

- ◆ Section 2563 of the United States Code authorizes military facilities to sell certain articles or services to non-DoD entities, and thus in effect permits the facilities to act as subcontractors to private firms. This section contains the actual amended language regarding the indemnification requirement.
- ◆ Section 2474 directs the military services to designate depot-level activities as Centers of Industrial and Technical Excellence, and authorizes them to form public-private partnerships. It cites section 2563 and states that the amended hold harmless provision also applies to partnerships under section 2474.

There are other legal authorities for partnerships. For example, private firms entering into partnerships with Army depots have cited Title 10, section 4543, as the statutory authority for a partnership. Section 4543 authorizes Army industrial facilities that manufacture “large caliber cannons, gun mounts, recoil mechanisms, ammunition, munitions, or components thereof to sell manufactured articles or services to a person outside the Department of Defense.”⁷ This section does not contain any references to the amended hold harmless provision.

INDEMNIFICATION IN COMMERCIAL CONTRACTS

The issue of indemnification in public-private partnerships is, at its core, one of risk management. Commercial firms deal with risk management in their daily contractual negotiations with other commercial firms—hence our interest in examining how commercial firms treat indemnification in their contracts.

⁶ 10 USC section 2563 (c) (3).

⁷ 10 USC section 4543 (a).

In contracts between commercial firms, the prevailing method for managing the risk of non-performance, or legal liability due to third-party harm, is to use language from the Uniform Commercial Code (UCC). The UCC is a model statute of 11 articles that govern such matters as the sale of goods, credit, and bank transactions. It originated in 1942 from the efforts of its two sponsors—the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI)—to simplify, clarify, and standardize law on subjects where uniformity was desirable and practicable.

All states have adopted and adapted the entire UCC, with the exception of Louisiana, which adopted only parts of it. The main article that covers remedies for breach of contract is Article 2, “Sales.” In addition to remedies outlined in the UCC, commercial contracts use several other indemnification tools to minimize risk. Table 1 outlines the tools typically used in commercial contracting to manage the risk of non-performance, as well as the source of those tools.

The widespread use and acceptance of the UCC has provided many benefits to commercial companies in their contractual dealings with each other. The following benefits have had the greatest impact:

- ◆ Streamlining the size of the contract document
- ◆ Reducing the time and cost of contract negotiations
- ◆ Establishing a standard reference to help resolve disputes
- ◆ Ensuring completeness by providing default responsibility for situations not specifically addressed by the negotiated contract.

Despite minor differences in the UCC among states, the basic tenets detailed in the code have served commercial firms well in their contracts with each other, both within the same state and across state borders.

Table 1. Risk Mitigation Tools in Commercial Contracting

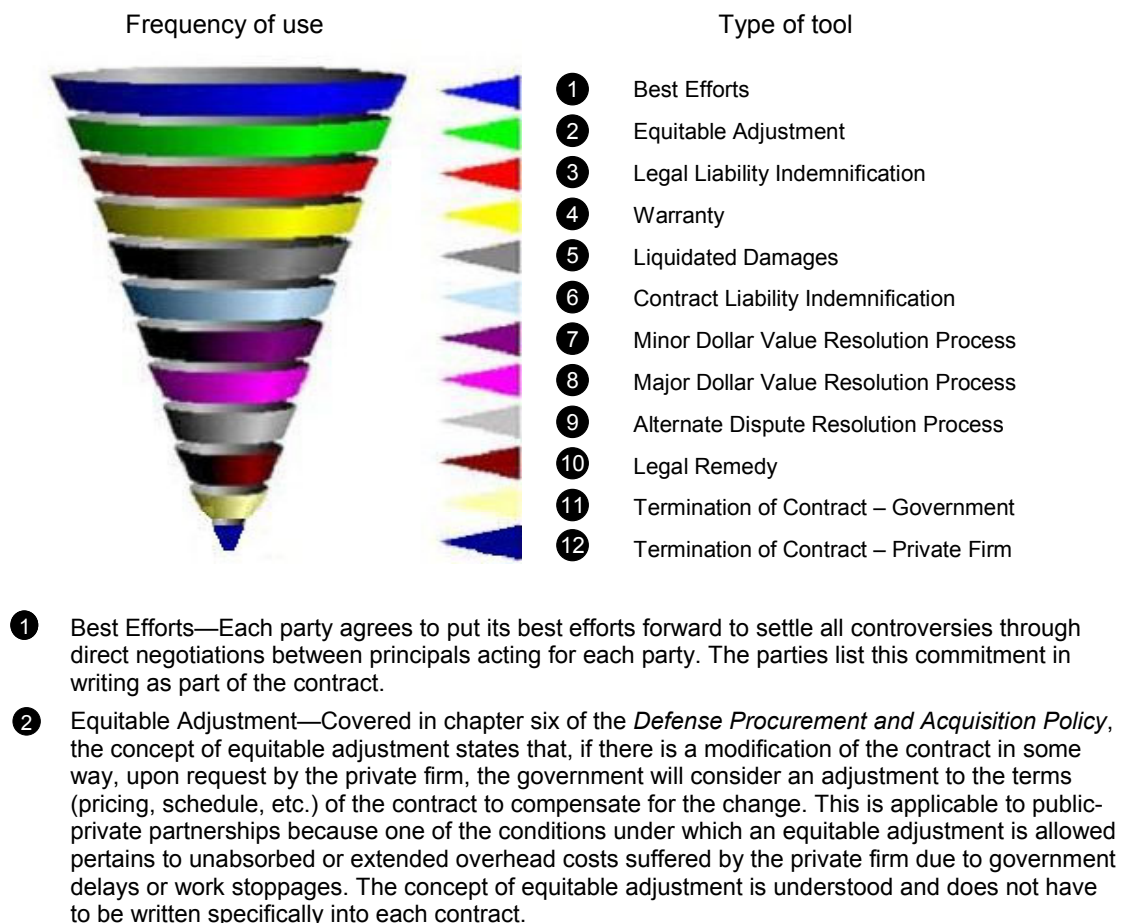
Tool	Description	Source
Identify the limit of liability	The service provider includes a provision to limit its liability to the maximum amount it receives under the agreement.	Non-UCC
Termination by the provider	Provider terminates the contract for cause or convenience.	Non-UCC UCC, Article 2, section 309
Termination by the buyer	Buyer terminates the contract for cause or convenience.	Non-UCC UCC, Article 2, section 309
Insurance requirement	The hiring company requires a minimum level of insurance from the service provider so that negligence or liabilities are financially covered.	Non-UCC
"Force majeure" clause	In the event of war, acts of God, strikes, weather, or other uncontrollable circumstances, the parties are excused from performing.	Non-UCC
Non-solicitation	Each party agrees to a mutual restriction on soliciting employment from the employees of the other party.	Non-UCC
Contract breach in kind	Where one party's cooperation is necessary to the performance of the other and a breach of contract occurs, the other party is excused from delivering or accepting goods.	UCC, Article 2, section 311
Warranty	Provider of goods or services guarantees that the quality of its product conforms to what was agreed upon.	UCC, Article 2, sections 313–315
Standard delivery terms	Define the point at which responsibility for shipments and cargo transfers from seller to buyer, for various terms and methods of delivery.	UCC, Article 2, sections 319–328 UCC, Article 2, sections 509–510
Payment before inspection	Outlines the buyer's and seller's right in situations that call for the buyer to pay for goods prior to inspection.	UCC, Article 2, section 512
Inspection by buyer	Outlines rights and limitations of the buyer to inspect goods. This also covers which party pays for the inspection costs.	UCC, Article 2, sections 513–515
Buyer rejection of goods	Defines the buyer's rights and duties when rejecting goods.	UCC, Article 2, sections 601–605
Buyer acceptance of goods	Defines the point at which acceptance of goods becomes final and irrevocable, as well as notification procedures in the event of third-party litigation.	UCC, Article 2, sections 607–608
Assurance of due performance	Depicts rights of each party to suspend its performance if, after proper notification, the other party does not meet its contractual obligations.	UCC, Article 2, sections 609–616
Insolvency or non-payment of buyer	Outlines the remedies of the seller in the case of insolvency of the buyer.	UCC, Article 2, section 702 UCC, Article 2, sections 709–710
Buyer's wrongful rejection	Details the seller's options if the buyer does not rightfully accept goods as called for by the contract.	UCC, Article 2, sections 703–708
Non-conformance of goods or services	Defines buyer's remedies in the event of non-conforming goods or services.	UCC, Article 2, sections 711–717
Liquidated damages	Details the parameters for setting damages for breach of contract at a predetermined amount in the contract.	UCC, Article 2, sections 718–719
Right of action against third party	Outlines each party's rights to recoup damages against a third party that has been involved in providing the goods or services detailed in the contract.	UCC, Article 2, section 722
Evidence of market price	Defines the methodology for determining the current market value of goods or services.	UCC, Article 2, sections 723–724
Statute of limitations	Determines the time limit for initiating a cause of action to recoup damages. The default standard is four years from when the breach of contract occurred.	UCC, Article 2, section 725

Notes: Non-UCC = Historical practice based on British common law principles; UCC = Uniform Commercial Code.

HANDLING RISK IN PUBLIC-PRIVATE PARTNERSHIPS BEFORE 2001

A similar standard set of guidelines does not exist for dealing with indemnification contractually in a public-private partnership. However, even before the statutory revision of 2001, a typical public-private partnership contract could contain many different tools for handling non-performance by the public entity or legal liability by the private firm. These mechanisms remain available and in use today. We have identified these provisions through research of existing contracts and discussions with contracting officers, legal professionals, and the Defense Contract Management Agency (DCMA). Figure 3 and the subsequent notes provide a brief description of each and rank their frequency of use.

Figure 3. Dispute Resolution and Risk Mitigation Tools in Public-Private Partnerships



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- ③ Legal Liability Indemnification—The private firm supplier of goods and services usually carries professional liability insurance. This insurance provides protection from claims of harm caused to a party by the negligence of the insured in the performance of professional services. The private firm can request indemnification from the government for claims by a third party that exceed the private firm's professional liability insurance coverage. Provisions for this type of indemnification are covered under Title 50, U.S. Code, sections 1431–1435, and are discussed in section 52.250 of the Federal Acquisition Regulation. Inclusion of this type of clause in the contract lowers the private entity's perceived risk in the partnership.
 - ④ Warranty—An agreement between a buyer and a seller of goods or services, detailing the conditions under which the seller will make repairs or fix problems without cost to the buyer. Warranties are addressed in most public-private partnership contracts and can have a large impact on the perceived risk for both the private firm and public entity.
 - ⑤ Liquidated Damages—Contracts can provide for payment of a certain fixed amount in the event of a breach of the contract. The government uses liquidated damages clauses to account for probable damages in case of late delivery or untimely performance by the private firm. Therefore, the liquidated damages amount must be a reasonable forecast of just compensation for the harm caused by late delivery or untimely performance of the particular contract. It can be a tool for minimizing risk for both parties because it sets a fixed and agreed upon amount for damages due to non-performance of an aspect of the contract.
 - ⑥ Contract Liability Indemnification—Almost the opposite of the “liquidated damages” concept, a contract liability indemnification absolves the private firm of any penalty for damages due to non-performance for delivery, quality, or both.
 - ⑦ Minor Dollar Value Disputes—If a dispute remains unresolved after direct negotiations and the value is less than a certain threshold (typically \$10,000), the parties agree to have the dispute resolved by the commanding officer of the public entity. They agree, in writing, that this decision is “final and conclusive, and shall not be appealable or otherwise subject to challenge.”⁸
 - ⑧ Major Dollar Value Disputes—If a dispute remains unresolved after direct negotiations and the value is greater than a certain threshold (typically \$10,000), both parties agree to an administrative procedure that would be exhausted before future legal action could be undertaken. The procedure would involve a hearing by the commanding officer of the public entity, and a decision by the commanding officer with a time limit for appeal by the private firm. If the private firm decides to appeal, it must provide a written appeal to the next higher commanding officer at headquarters. This individual would conduct a hearing and make a decision. If the private firm decides to reject the decision of this officer, it has a time limit to then pursue any legal remedy available to it by law.
 - ⑨ Alternate Dispute Resolution—The parties may each select an objective third party to represent them in a process directed and facilitated by an administrative law judge of a board of contract appeals. The resolution of the dispute is by mutual agreement of the parties.
 - ⑩ Legal Remedy—Legal remedies include bringing the matter to the Armed Services Board of Contract Appeals, submitting the issue to an alternative dispute resolution procedure as authorized by the Administrative Dispute Resolution Act of 1996 (Pub. L. 104-320), or other legal remedies consistent with the requirements of Title 10 of the United States Code, section 2553.
 - ⑪ Termination of the Contract by the Government—The government may terminate the contract with the private firm for either cause or convenience. Usually the government pays the private firm for work performed up to the notice of termination and reasonable charges, if it terminates the contract for convenience. If the government terminates the contract for cause, it typically is not liable for any costs except for finished goods and services, less any penalties. Termination for cause is a lose-lose situation and is only used as a last resort.
 - ⑫ Termination of the Contract by the Private Firm—The private firm may terminate the contract with advance written notice to the public entity. Usually, the private firm remains responsible for costs incurred by the public entity up to the date of receipt of the termination notice, as well as costs to tear down any facility, or return any facility to its condition prior to the contract start.

⁸ “F/A-18E/F Integrated Readiness Support Teaming (FIRST) Program,” Commercial Service Agreement between the McDonnell Douglas Corporation and Cherry Point Naval Aviation Depot, June 21, 2001, p. 5.

As Figure 3 shows, although there is no formal set of guidelines like the UCC for negotiating a public-private partnership contract, both public and private entities have quite a few tools available for managing risk, beyond the indemnification provisions of federal law.

PERCEPTIONS OF RISK AFTER 2001

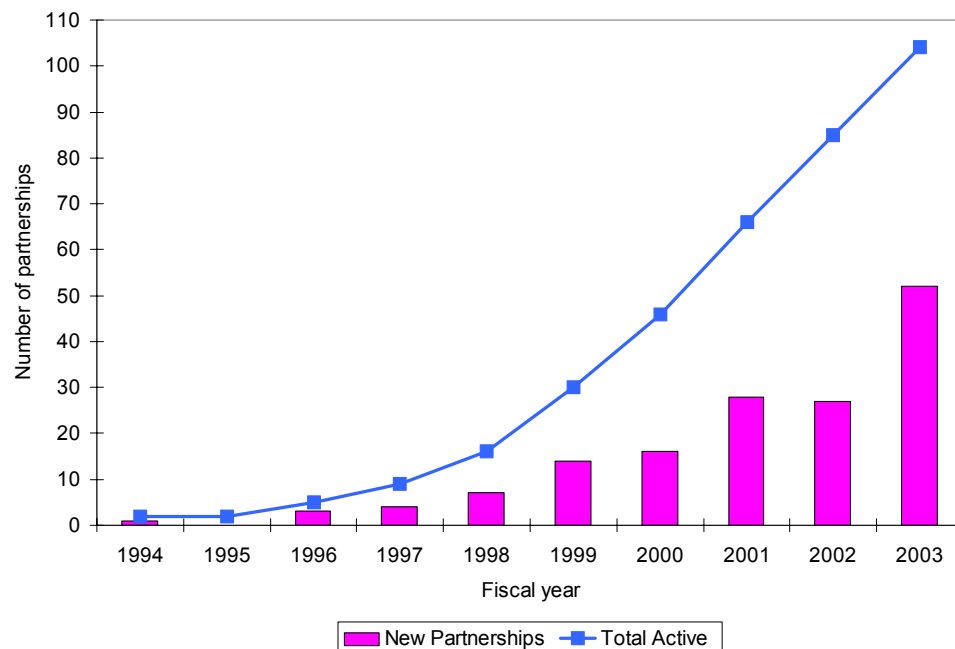
Although perceptions are difficult to gauge, evidence suggests that private firms believe the current benefits of teaming with a government entity far outweigh the risk of contractual penalties or legal liability. This evidence can be seen in three areas:

1. Data showing continued growth in partnerships
2. Availability and use of indemnification tools
3. Sentiment of key private firms.

Continued Growth

Current trends demonstrate continued growth in the number of public-private partnerships. Figure 4 shows that the overall number of active partnerships increased more than fivefold between 1998 and 2003.⁹

Figure 4. Growth in Depot Maintenance Public-Private Partnerships



⁹ Analysis of data from *Public-Private Partnerships for Depot-Level Maintenance*, a briefing presented July 2003.

It is not only the number of partnerships that is growing. The number of both organic maintenance depots and private firms that are partnering is increasing significantly, as shown in Figure 5 and Figure 6.¹⁰

Figure 5. Number of Organic Maintenance Depots Involved in Partnerships

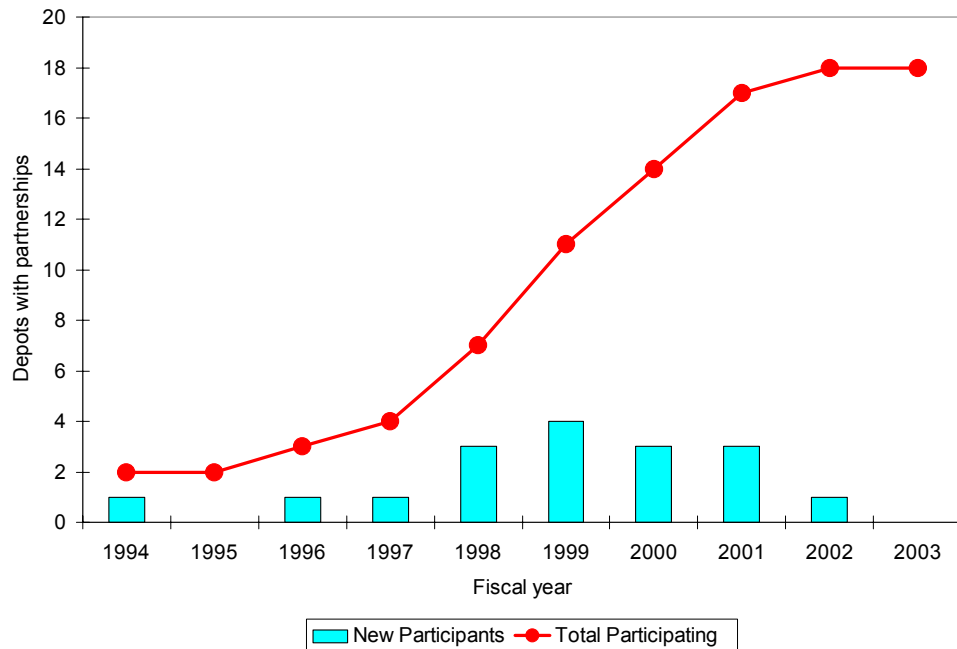
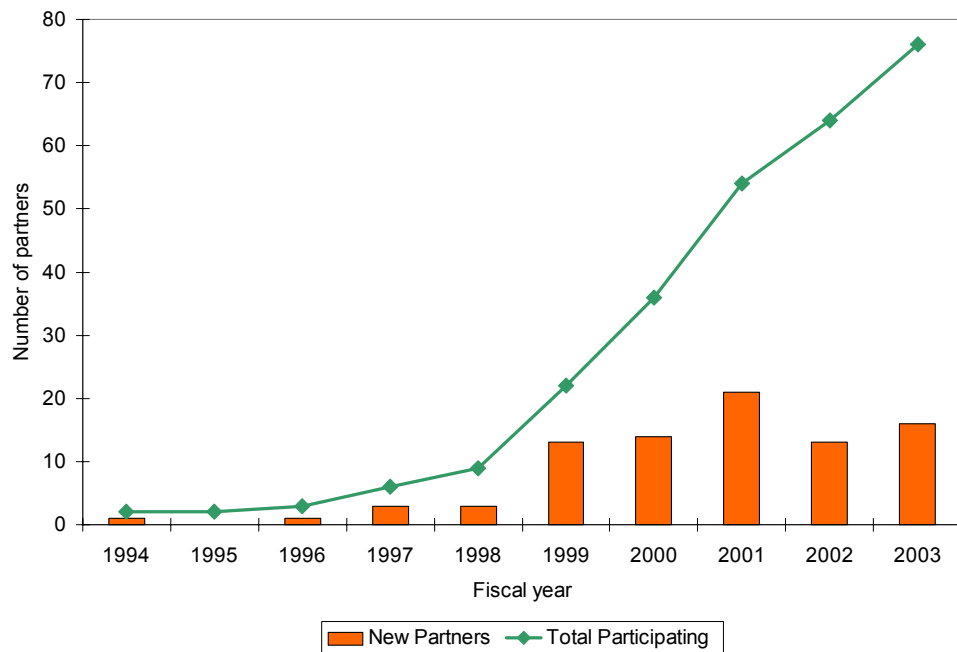


Figure 6. Number of Private Firms Involved in Partnerships



¹⁰ Ibid.

This notable growth in partnerships provides some objective evidence that private firms continue to find the risk-reward tradeoff attractive for entering into this type of arrangement with an organic maintenance depot. The growth was apparent even before Congress broadened the statutory exceptions to indemnification in 2001, and it continued unabated thereafter. In other words, despite concerns voiced by the private sector, the issue of indemnification has not been a barrier to increased levels of public-private partnerships.

Availability of Indemnification Tools

Prior to the statutory change in 2001, private firms had 12 different options available for resolving government depot performance issues, or minimizing the risk of potential loss or damages from a contract breach (See Figure 3.). In addition, many options have been available in the UCC that a private firm and a government entity could adapt into contract language.

Of the 99 public-private partnerships formed between 1994 and the end of 2002, 38 used Title 10, section 2563 or section 2474, of the United States Code as the statutory authority. Although the change in the hold harmless clause of these authorities has yet to be tested, the government is considering changes to the Financial Management Regulation (FMR) to account for the amendment. These changes would provide funding and accounting guidance for potential claims should a private firm elect to pursue legal action according to the amended hold harmless provision of section 2563.

To date, none of the partnerships involving depot maintenance have ended in the termination of the contract by the private firm because of non-performance by the public entity.

Because of the number of potential remedies for mitigating risk, the lack of use (to date) of the new hold harmless clause, and the fact that none of the partnerships formed since 1994 has dissolved because of the depot's non-performance, we can reasonably conclude that either depot non-performance is not a prevalent issue, or it has been resolved through intermediate steps short of termination of the contract by the private firm. The change to the public law in December 2001 further lessens what already appears to be a fairly low risk.

Sentiment of Perceived Risk

As evidenced in interviews, the prevailing sentiment among knowledgeable members of key defense contracting firms is that indemnification is currently a low-level concern at most.

Roughly 60 percent of those who gave their views stated that indemnification is not a barrier to growth in public-private partnerships, and that risk levels were low. These interviewees felt that partnerships were based on a relationship of trust, and that they had sufficient remedies to deal with an organic maintenance

depot that started to perform poorly. For example, the private firm could help a depot with non-performance by implementing commercial best practices within the supply chain, training depot personnel, or even placing its own employees on site until the problem is resolved. However, these individuals felt the change in public law did help to lower the risk of partnering with an organic maintenance depot.

The remaining 40 percent of interviewees felt a public-private partnership posed some risk, but they held different views of where the biggest risk was. We found it interesting that, even though this group still perceived risk, they also enumerated methods they planned to use or have already used to mitigate that risk. These views are summarized in Table 2.

Table 2. Private Firms' Perception of Risk and Remedies

Perceived risk	Proposed remedy
As a counter to the change in public law, the depot would write into the contract the costs for which it would not be held liable.	Use language of 10 USC section 2563 as the default language.
Contract uses 10 USC section 4543, which applies only to Army facilities as the statutory authority for doing business with an organic depot, but which contains only the "willful misconduct or gross negligence" exemption from indemnification. It does not contain the "quality, schedule, or cost" exemptions.	Use 10 USC section 2474 as the statutory authority for partnering with a government depot. These sections contain the exemptions for quality, schedule, or cost.
Contract uses 10 USC section 4543 as the statutory authority for doing business with an organic depot, which does not provide relief from the requirements of section 2466 (a), the "50/50" law, limiting the use of depot maintenance and repair funds.	Use 10 USC section 2474 as the statutory authority for partnering. This explicitly exempts contractor costs at a public depot for the performance of depot-level maintenance and repair pursuant to a partnership agreement from being counted toward the "50/50" requirement.
Contract uses 10 USC section 2563 as the statutory authority for doing business with an organic depot. This exposes the private firm to the possibility of legal liability from a third party, which arises from the articles or services provided by that firm.	Use 10 USC section 2474 as the statutory authority for partnering. This section contains a hold harmless and indemnification provision for use of the Center of Industrialization and Technical Excellence <i>equipment or facilities</i> only. There is no hold harmless provision for the sale of goods or services in 10 USC section 2474. Using 10 USC section 2474 as the statutory authority for partnering allows the private firm to negotiate their own terms of indemnification for the sale of goods or services.
The hold harmless clause in the case of "war or national emergency" still presents a risk.	No solution offered.

The final risk listed in Table 2 (for which no solution is proposed) indicates the government reserves the right to suspend or terminate use of equipment or facilities during a war or national emergency. Should this happen, and should the private firm suffer consequent damages, it would have no recourse to recoup its

losses. However, although private firms do bear this risk of loss, they all agree it is extremely unlikely that the government would suspend or terminate essential maintenance services on weapon systems during a war or national emergency. This is especially true because the great bulk of partnership workloads support Department of Defense customers. The issue private firms have of suffering damage due to the government changing or canceling a contract because of “war or national emergency” appears to be the remaining concern among key defense contracting firms for which there is not an identified solution.

Most of those interviewed stated that indemnification is no longer a barrier to growth in public-private partnerships, and the likelihood of the government invoking the “war or national emergency” clause is extremely remote. Therefore we can infer from industry sentiment that indemnification is a low-level risk to future growth in public-private partnerships.

The attitude of both parties is, perhaps, the best weapon against failure of a partnership and an explanation for why the number of partnerships continues to grow steadily. As one industry executive said:

With the change in the law, yes it did help to mitigate risk, and with other changes in law, it broadens the perspective of partnerships, and helps to set clear guidance for contractual performance standards. Overall, if the law would not have changed, I think that partnerships would have moved forward, maybe a little slower and with caution, but it still was doable for both parties. The key is trust... Both the leadership and technicians at a depot do not want to fail. For the continued sustainment of weapon systems, it is critical that the government agencies use not only their resources but the commercial sector resources to meet the requirements of the warfighter. Partnerships are the key!

CONCLUSIONS

Public-private partnerships can create a three-way success for the commercial firm, the public entity, and the warfighter. The requirement that the private firm indemnify the government is a low-level concern at most, and it is not a barrier to increased public-private partnerships. The history of partnerships shows continued significant growth, and no case of early termination of the contract by the private firm for poor depot performance. Numerous tools are and have been available to be written into the contract to mitigate the risk of depot non-performance and third-party legal liability. Sentiment among the private firms confirms that the indemnification risk, if it was ever a barrier to partnerships before December 2001, has been lessened by the public law change.